CLIENT ALERT

Delaware Chancery Court Issues Landmark Decision on "Material Adverse Effect" Clause

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In the first post-trial decision under Delaware law upholding the termination of a merger agreement based upon the occurrence of a material adverse effect ("MAE"), on October 1, 2018, the Delaware Court of Chancery ruled that German pharmaceutical company Fresenius Kabi AG ("Fresenius") had properly terminated its $4.75 billion acquisition of Akorn, Inc. ("Akorn"), an Illinois-based specialty generic pharmaceutical company. The Court's opinion, which is 247 pages long, represents one of the most exhaustive pronouncements in recent years on the standards under Delaware law for establishing an MAE as well as the proper interpretation of covenants to operate the business in the "ordinary course" between signing and closing. The opinion has generated much publicity and Akorn has announced its intention to appeal to the Delaware Supreme Court, which ultimately will be the final word on these important issues.

Background

In April 2017, Fresenius agreed to acquire Akorn for $34 per share. The merger agreement included standard representations and warranties by Akorn, including that it was in compliance with applicable regulatory requirements (the "Regulatory Representation"). The merger agreement also required Akorn to use commercially reasonable efforts to operate in the ordinary course of business in all material respects between signing and closing (the "Ordinary Course Covenant"). Fresenius could terminate the agreement if Akorn's representations and warranties were not true at signing and closing and the deviation would reasonably be expected to result in an MAE. Fresenius could also terminate if Akorn had failed to comply in all material respects with its obligations under the merger agreement. Finally, Fresenius would not be required to close if Akorn suffered a "general" MAE (*i.e.*, an MAE not tied to a specific representation).

According to the Court, after the merger agreement was signed, Akorn's financial performance "fell off a cliff," with the company's revenue and earnings growth declining precipitously. For example, the Court noted that Akorn reported declines in revenue, operating income and earnings per share for fiscal year 2017 of 25 percent, 105 percent and 113 percent, respectively, over the prior year. Similarly, the same metrics for the first quarter of 2018 were reported to be 27 percent, 134 percent and 170 percent less than the same quarter in the prior year. In addition, Akorn's EBITDA for 2017 experienced a year-over-year decline of 86 percent. Akorn attributed the poor performance to various factors, including unexpected new market entrants for its three top products, new competition in another important product and loss of a key contract.

Separately, the Court noted that in late 2017, Fresenius received the first of several whistleblower letters alleging serious problems at Akorn concerning product development and quality control processes. Using its broad information access rights under the merger agreement, Fresenius conducted a comprehensive investigation with the assistance of outside regulatory counsel and consultants. As detailed in the Court's opinion, the Fresenius investigation uncovered "pervasive data integrity and compliance problems" at Akorn, including instances of falsified data submitted to the FDA. According to the Court, Akorn failed adequately to investigate and remediate these issues both before and after signing the merger agreement. The Court was also seriously troubled by evidence showing that, after signing, Akorn materially scaled back its quality control and related IT functions without Fresenius's consent.

Based on its investigation findings and Akorn's dismal post-signing performance, Fresenius terminated the merger on April 22, 2018, citing as grounds Akorn's breach of the Regulatory Representation and the Ordinary Course Covenant and the occurrence of an MAE. Akorn filed suit the next day seeking specific performance of the merger agreement. Fresenius counterclaimed and sought, among other things, a declaration that it was permitted to terminate the transaction based on Akorn's breaches. The Court granted Akorn's request for an expedited trial, which took place from July 9 to 13 and during which the Court heard evidence from 16 fact and expert witnesses.

Key Findings

In ruling for Fresenius, the Court concluded that Fresenius had satisfied its burden in establishing three separate grounds upon which it could avoid closing the deal.

Akorn Suffered a General MAE

While acknowledging the "heavy burden" imposed on a buyer attempting to invoke an MAE clause, the Court found that Fresenius had satisfied the burden by proving that the material decline in Akorn's performance was not a "short-term hiccup," but rather "durationally significant" because it had persisted for a year and "show[ed] no sign of abating." Further, the "sudden and sustained drop" was a significant departure from the consistent growth experienced by Akorn in the years preceding the signing of the merger agreement.

The Court rejected Akorn's argument that the decline should be measured against the value of the post-merger combined entity (including synergies), thereby reducing the percentage magnitude of the decline (by increasing the "denominator"). Rather, the Court found that the MAE provision itself made clear that changes in value were assessed relative to the seller as a stand-alone entity and excluded any synergies.

The Court also found that while the events causing Akorn's problems were "unexpected" and "unforeseen," it would be contrary to the language and purpose of the MAE clause to read into the merger agreement, as argued by Akorn, a "tort-like concept of assumption of risk" that would preclude Fresenius from establishing an MAE based on risks it contemplated, or matters that were either disclosed to it during diligence or publicly known.

Finally, the Court held that the cause of the decline was not, as Akorn contended, "industry headwinds" that would be excluded from the contractual MAE definition, but rather "endogenous risks specific to Akorn's business." Even if the decline was the result of industry-wide effects, the evidence showed an impact on Akorn that was disproportionate to that of its peers, thereby bringing these effects back within the MAE definition.

Akorn's Breach of the Regulatory Representation Would Reasonably Be Expected to Result in an MAE

The Court held that evaluating whether an untrue seller representation "would reasonably be expected" to result in an MAE required analysis of both "quantitative and qualitative aspects." According to the Court, the falsity of Akorn's Regulatory Representation was qualitatively material because "Akorn has gone from representing itself as an FDA-compliant company with accurate and reliable submissions from compliant testing practices to a company in persistent, serious violation of FDA requirements with a disastrous culture of noncompliance." Likewise, from a quantitative perspective, the Court found that estimated remediation costs of approximately $900 million, or 21 percent of Akorn's equity value, would be material "when viewed from the longer-term perspective of a reasonable acquirer." However, the Court cautioned readers not to "fixate on a particular percentage as establishing a bright-line test" and acknowledged that its use of remediation costs (as opposed to other metrics) to evaluate quantitative materiality of the Regulatory Representation breach was based on the parties' submissions.

As with the general MAE claim, the Court again rejected Akorn's argument that Fresenius's "general knowledge about potential regulatory issues" precluded it from relying on the Regulatory Representation. In particular, the Court did not view the addition of an MAE qualifier to the representation as changing its fundamental nature or purpose, which is "an effort by the parties to allocate … risk."

Akorn Breached the Ordinary Course Covenant

The Court viewed the Ordinary Course Covenant as imposing an obligation on Akorn to "take all reasonable steps" to maintain its operations between signing and closing. The Court rejected Akorn's argument that the "in all material respects" qualifier required Fresenius to prove that Akorn's conduct met the stringent standard of "material breach" under

Delaware law. Rather, borrowing from the disclosure case law, the Court held that "material" had a less onerous meaning in this context, requiring only that Akorn's breach would have been "viewed by the reasonable investor as having significantly altered the 'total mix' of information."

Applying these standards, the Court found that Akorn breached the Ordinary Course Covenant in multiple ways, including by cancelling or curtailing audits, failing to remediate known issues, halting expenditures on data integrity projects, submitting fabricated data to the FDA, and failing to conduct an independent investigation into the whistleblower allegations.

Conclusion

Although involving an extreme set of facts, as to both Akorn's pervasive regulatory issues and its dramatic post-signing financial collapse, the *Fresenius* decision nevertheless is an invaluable guide to deal participants and professionals. The decision underscores the importance of well-drafted representations and warranties, interim operating covenants, and MAE provisions, and provides concrete examples of how seemingly minor changes to such provisions can affect the outcome in later litigation between the parties. From the buyer's perspective, understanding these nuances and applying them to drafting what may otherwise be viewed as standard provisions can lay the groundwork for a successful exit from (or leverage to renegotiate) an improvident deal. It remains to be seen how the Delaware Supreme Court addresses these issues.

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